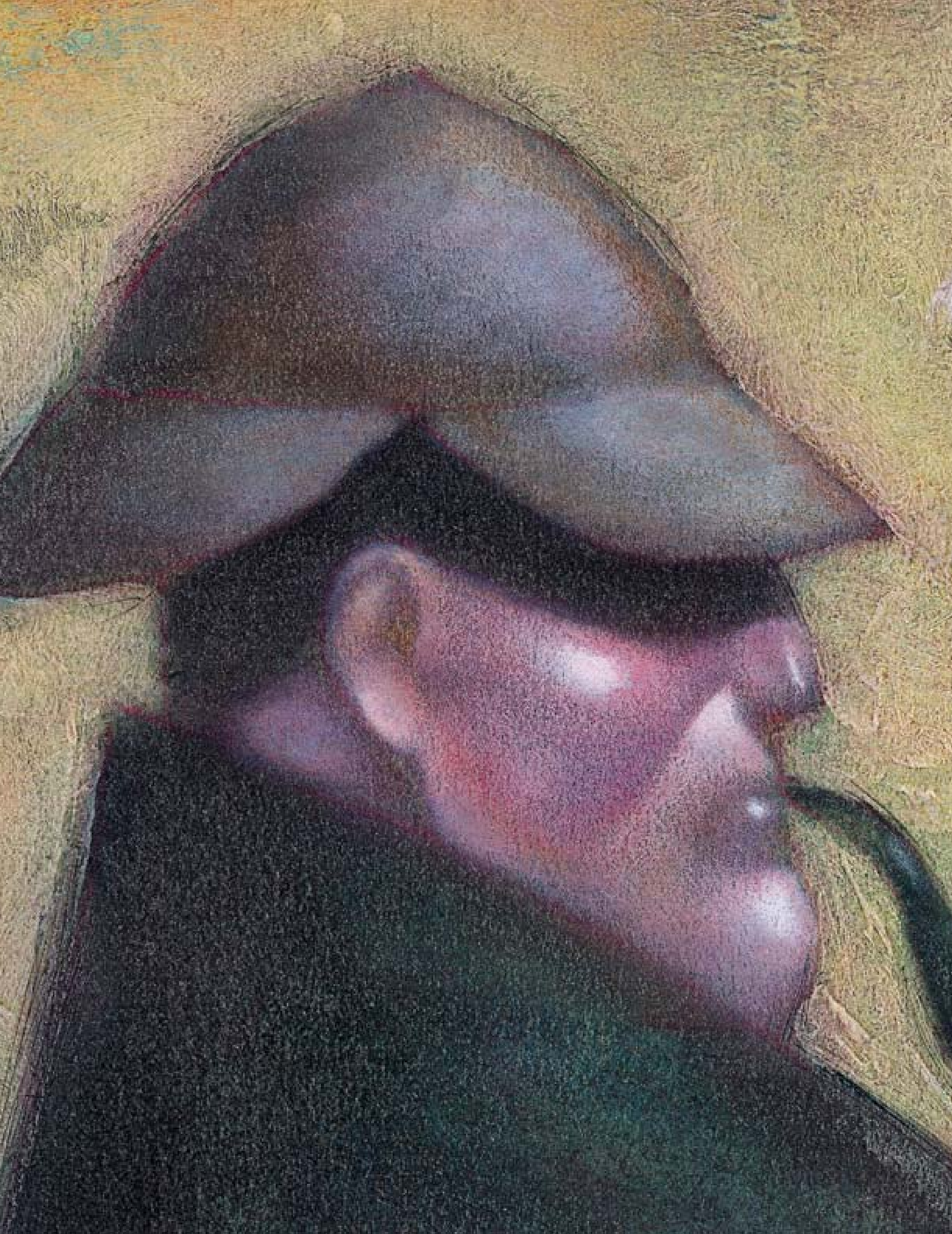

Sleuthing for Unrecorded Income

By Michael Goldman, MBA, CPA, CVA, CFE

Divorce and bankruptcy situations often lead to charges of misappropriated income. The methods used to hide income include not recording cash receipts (getting paid under the table), bartering, diverting income to another entity, overstating costs and expenses (thus understating profits), paying expenses of another entity, and deferring income to a later time period.

Detecting these tricks requires applying both experience and knowledge in a creative fashion, and being alert to transactions and happenings (or the lack thereof) in the context of their expected setting. Suspicion, inquisitiveness, and a willingness to dig beyond what is presented to you are critical elements in finding unreported income.

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The first step in an unrecorded income investigation is gathering the facts. If the target is an individual, these facts would include:

- Personal financial statements and tax returns
- Schedules of investments, receivables, credit cards, bank accounts, assets (such as real estate, vehicles, jewelry, collectables), safe deposit boxes, etc.
- Bank statements with cancelled checks, brokerage statements, loan statements, credit card statements, etc.
- Copies of contracts, employment agreements, leases, etc.
- Copies of all credit applications made in the past three years
- Copies of insurance policies
- An interview with the upset spouse (in divorce proceedings) or employees of the debtor (in bankruptcy proceedings)

Gathering Personal Facts

Here are a couple of examples that demonstrate the value of those records. First, a franchisor asked me for an opinion as to whether one of the franchisees was skimming cash and not paying royalties. Fraud was suspected because the franchisee's operating margins were considerably lower than the average, and revenues appeared to be too low relative to the amount of materials the franchisee was buying. Terms of the franchise agreement called for franchisees to provide copies of their tax returns upon request. The franchisee's personal tax returns over four consecutive years showed no sources of income besides his business, and no investment income that would indicate a large nest egg to live on. A look at the deductions on the tax returns showed that for four consecutive years this person paid out more in mortgage interest, real estate taxes, college tuition for his children, and health insurance premiums than he earned in his business. When he couldn't explain how he maintained that lifestyle on his reported income, he admitted to cheating on his royalty payments.

A fascinating divorce case I worked on involved a husband who owned a cash business and a wife being paid considerable cash commissions for referrals she made while working as a concierge in a major downtown hotel. While their joint tax returns never showed more than $45,000 of income, they drove matching Jaguars (fully paid for), took lavish vacations, wore expensive clothing and jewelry, and built quite a nest egg for themselves. The couple had done a remarkable job of paying cash for almost everything they bought, but there are some things—like insurance policies and airline tickets—where cash just isn't practical; and nowadays nobody has expensive assets such as Jaguars and jewelry that they don't list on an insurance rider somewhere. After adding up all their spending and investing for a three-year period, the wife determined how much her real income had been. The difference between her inflows and their combined outflows was determined to be the husband's real income. The wife's reported income was $24,000 per year in salary, and she received about of $60,000 per year in cash commis-

9 Key Steps in an Unrecorded Income Investigation

1 **Objective.** Determine the objective of the investigation (find hidden marital assets, document criminal activity, determine the need for enhanced business control, etc.) and the known facts from the client and the client's attorney. Establish exactly who your client is (company, spouse, attorney, creditor, etc.) and the role that you are retained in (investigator, consultant, or expert).

sions. Based on the wife's description of their standard of living (groceries, restaurants, entertainment, clothing, etc.), we were able to estimate that the couple spent $6,000 per month on routine cash purchases. After adding in mortgage payments, taxes paid, utilities, and large asset purchases (cars, jewelry, investments) we were able to come up with a net outflow of about $280,000 for each of the last two years. By subtracting the $84,000 of annual income attributed to the wife, we derived an income figure of $194,000 per year for the husband.

A common finding in cases like these is that the subject being investigated has committed tax fraud. It is unethical to threaten criminal prosecution to achieve a settlement in a civil matter. On the other hand, demonstrable tax fraud hurts the subject's credibility in whatever they testify about, and many states require judges to report tax fraud that comes to light in their courtrooms. Typically, these cases reach some kind of settlement before the report is ever completed and presented.

Gathering Business Facts

For businesses, the list of facts to gather would include those listed above, plus budgets and forecasts, business plans, accounting detail (general and subsidiary ledgers), inventory worksheets, promotional materials, price lists, material lists, list of significant customers and vendors, commercial leases, etc. It also helps to gather information such as trade associations that the company belongs to and industry statistics (like key ratios), so you can form expectations of what should and shouldn't be found in the company's accounts

In one divorce case involving a mortgage broker, all of the mortgage broker's tax returns and financial statements appeared reasonable at first glance. It wasn't until I reviewed industry statistics and talked to people in the industry that I realized that the commission rates as a percentage of sales paid by this company were 40 percent higher than normal industry practice. After determining that the commissions reported were not overstated, and the sales personnel were not being paid higher rates than their peers in other companies, we were able to uncover substantial underreporting of the company's revenues. It was then a simple matter to calculate how much additional revenue would be needed to bring the commission rates and sales back into line with industry averages, which was the amount of income that was unreported. Unfortunately for the mortgage broker, he refused to accept this calculation, which led to subpoenas of bank and credit card records and the discovery of furs, trips, hotel stays, flowers, and clothing, about which his wife knew nothing.

It is a common investigative practice when reviewing a business to compare operating statistics to industry averages, and to trends over time. Much fraud is detected because the financial statements do not make sense. Investigate all abnormal relationships (e.g., ratios, margins, and cause-and-effect dependencies) or trends. As in the example above, a company paying an average of 30 percent of its revenues out as commissions, when the industry average is 10 percent and the variance from the average tends to be minimal, is probably either overstating its commission expense or understating its revenue. When a business that has consistently made a 40 percent gross margin for years all of a sudden slides to a 20 percent margin, it may be experiencing operating problems, or somebody may be skimming income out of the company.

Soon-to-be ex-spouses or disgruntled (and often non-gruntled) employees are usually excellent sources of information. While a spouse may

2 **Operations.** Understand the business or individual's operations—how do they make their money, what types of transactions take place, how are these accounted for, what type of trails do they leave, and what opportunities for concealment are there?

3 **Documents.** Gather and analyze the key documents and files that are discussed in the article. Focus on consistency and logic: Does everything fit together and make sense? Review the details carefully—front *and* back sides of cancelled checks, both sides of transactions purporting to transfer funds from one bank account to another, vendor names and addresses, contract obligations, etc.

have no idea how much money their partner really made, they can provide extensive detail about their standard of living and are often quite proud that they were able to run personal expenses through the business. Employees of a bankrupt company are usually eager to discuss the unusual things that management did to enrich themselves while the employees were losing their jobs and health insurance.

In a recent bankruptcy fraud case, a former employee mentioned getting her last paycheck from an out-of-state bank. This in turn led to a conversation with the former mail room clerk, who said that the owner of the company routinely instructed her to make Federal Express shipments of customer payments to this undisclosed out-of-state-bank. This led to the discovery of $650,000 that had been diverted out of the bankruptcy estate and not reported on any of the required operating reports.

Besides talking to employees, read whatever company documents you can get your hands on. Another case that I am currently involved in revolves around a retailer who made up-front payments to landlords for leasehold improvements. The debtor-company recorded these as fixed assets. A review of the leases showed that the landlord was required to rebate these payments after a certain period of occupancy. The owner of the company was having the rebates, as much as $250,000 each, paid to him personally and deposited into his personal account. These payments were never in the accounting records and would not have been found if we had not carefully read the leases. This retailer also had volume rebate agreements with some of its suppliers, and these rebate payments were also being diverted.

Sometimes the absence of something that you expect to be there can be an indicator of a fraud. High-volume cash businesses that hire unskilled labor as cashiers can almost guarantee that there will be cash overages and shortages when the funds in the registers are counted each night. These careless mistakes are a fact of business life and occur routinely. Cashier overages occur infrequently because the customer usually catches the error if they are short-changed, but shortages are bound to happen over the course of a busy day when cashiers are under pressure to move customers through the lines quickly. If you are reviewing a cash business such as this and notice that the cash count is always perfect (no overages or shortages), you can be fairly certain that there is manipulation going on—somebody is taking cash and forcing the records to reflect only the cash that is left, not the total sales.

Understand the Business

A thorough understanding of the target company's business, system of accounting, and internal controls is necessary to evaluate the information obtained. You should be able to answer the following questions:

- Are cash or barter transactions typical in this kind of business? If so, are they detectable?
- Are there controls in place to ensure that all transactions are recorded? If not, how can you go about finding unrecorded transactions?
- What kinds of activities are most likely to be unrecorded? Are there any indicators that could be used as a proxy for the unrecorded activity (as in the laundromat example)?
- Where are erroneous items most likely to be recorded (for example, cost overstatements or personal expenses run through the business)?
- Is there anything that you should expect to find in the accounting records that is not there?

4 **Control.** Analyze the subject's control over the accounting system relative to his or her financial management and accounting expertise (which they will usually grossly understate if they are involved in fraud), and relative to the documents being reviewed. For example, financial unsophisticates typically have few accounts with financial institutions, while financially sophisticated people tend to have multiple accounts. Finding many accounts for a subject who proclaims ignorance is a good tip-off to concealed activity. Another is finding the initials of the person who "never gets involved in that accounting stuff" on numerous accounting documents.

- What are the main activities of the business, and what evidence exists to document the activity levels? This evidence may be outside of the accounting records. For example, vehicle maintenance records are usually kept separate from the accounting records, but they provide excellent evidence of numbers of miles driven for trucking companies, limo and messenger services, etc.

An example of how this type of analysis can determine unrecorded income is in the case of laundromats, a classic cash business with very few trails of the cash that actually comes in. It is fairly easy, however, to determine for a given type of washing machine how much water and electricity it uses per load of laundry. Manufacturers, vendors, trade associations, and even some utilities can provide this information. You can also determine how much gas and/or electricity the specific dryer models consume during a standard cycle. Analyzing a laundromat's utility bills can give a fairly accurate measure of machine usage, which can then be used to derive how many coins must have been deposited during a given period.

I investigated a retailer that replenished the cash in the store's ATM machines with money from the store safe. It turns out that the ATM machines were owned by a different company, and when the bank reimbursed the owner of the ATMs for the money withdrawn by customers, that money was effectively siphoned out of one company and into another. To detect this kind of fraud, you have to understand how the business of providing ATM machines works: You put your money into the machine to stock it, customers take the money out with their ATM cards, and the bank that clears those transactions sends you a wire transfer to reimburse you for the money you put into the machine plus a small service fee. Looking for the ATM reimbursements that weren't there helped bring this scheme to light.

Al Capone Method

Another method used to determine net income is the net worth method, which was first successfully used in the tax fraud case of Al Capone. The investigator adds up all assets and liabilities of the subject to calculate a net worth figure from bank statements, brokerage statements, insurance policies and the other information sources mentioned above. Changes in net worth from one period to another must equal the subject's net income. A concern in using this method is that the initial or base net worth figure may be understated due to hidden assets, or that subsequently obtained assets may not be visible to the investigator. The method may not be totally reliable, but is better than no method at all, and if anything the problems mentioned will understate the income you derive, not overstate it.

I was involved with a divorce case in which the husband disclosed $4 million of assets and $350,000 a year in income. Two-and-a-half years later, when he and his new wife applied for a mortgage, he listed $9 million in assets. We were able to establish that his income had not substantially increased, the values of the assets that he had disclosed had not substantially increased, and that the new wife had not brought any assets to the marriage. The only remaining conclusion, therefore, was that assets had been understated in the divorce disclosures.

A variance of the net worth method is being able to show that the subject under investigation spent more money than could be accounted for by his available assets and income. Review the subject's standard of living: expenditures for mortgage and car payments, education, grocery, enter-

5 **Curiosity.** Be intensely curious about everything that you look at. By definition, fraud is a disguise set up by someone in a position of trust. It is usually first uncovered by pulling on a little string that looks out of place or inconsistent with the things around it, then unraveling the whole scheme.

6 **Evidence.** If you believe that a fraud did in fact occur, you must gather evidence of when, how and by whom it was perpetrated, and what assets were involved. Quantify the extent of the fraud that you have discovered.

tainment, travel, clothing, domestic help, health care, home improvement, etc. Even in today's society, where most consumers are overextended in debt, the money had to come from somewhere, and if that somewhere is not identifiable, then there must be unrecorded income.

Clues in the Documents

After reviewing the big picture, you will often find indicators of hidden income, and tips on where to look for it, buried in the accounting detail or in other documents. The following are common sources of leads:

- Phone records with frequent or consistent calls to a specific number could lead an investigator to customers, vendors, brokers, or banks with whom transactions are being conducted but not recorded. A large number of calls to an area code where a company did no business led one investigator to find a bankrupt debtor's undisclosed vacation home.
- Frequent flyer statements and passports can give indications of both expenditures and destinations that may not appear anywhere in the general ledger.
- Utility bills can often be used to help determine revenues by indicating how much revenue-generating machinery and equipment is being used.
- Cancelled checks contain a wealth of information, including who actually cashed the check (as opposed to the payee recorded in the accounting records) and what bank and account it was cashed into. I recently completed a bankruptcy fraud case where we subpoenaed cancelled checks from the debtor's customers, and found five undisclosed bank accounts that the debtor was diverting cash to, by reviewing the endorsements and the bank stamps on the backs of the checks.
- Consumption: Laundry bills or detergent purchases will give a good indication of actual room usage in a hotel, or table turnover in a restaurant using cloth tablecloths and napkins. An Asian restaurant that gives a set of disposable chop sticks to each patron can have its total receipts estimated fairly accurately by multiplying the average charge per customer by the pairs of chopsticks consumed.
- Excessive inter-company transactions between related entities are usually an indication of a trail being intentionally obscured. In a bankruptcy fraud case I recently investigated, the debtor made continual transfers from one bank account to another. When the money left one of the bank accounts, it was recorded on the bankruptcy operating reports as an inter-company transfer to another debtor account, which was true. Some of those transfers, though, were recorded as customer remittances into the receiving bank account on the bankruptcy operating report, and not as the inter-company transfers that they really were. By doing that, the debtor was double-counting the same money as having been received from two different customers, and was hiding the fact that customer receipts were being skimmed into personal (non-debtor) bank accounts.
- An absence of expected payments in a subject's personal accounts, such as for utilities, auto expenses, insurance premiums, travel and entertainment, legal bills, etc., could indicate that they were being run through the business. The valuation of small businesses in divorce cases almost always require normalization adjustments for these personal expenses, and sometimes the

7 **Proof.** Depending on the case, subpoena or otherwise request additional documents (e.g., undisclosed bank accounts that you found transfers into, remittance records of large customers, regulatory filings, etc.) that will help further substantiate and quantify the fraud.

8 **Communication.** Alert your client and/or the client's attorney about your discoveries.

9 **Reporting.** Prepare your report(s) based upon the original objectives of the engagement best way to find them is to sit with the out spouse and go through all of the household expenses and determine which ones the family paid for and which the business paid for.

- Direct observation: Electrical contractors, HVAC repairmen, plumbers, installers, etc., often have vans and storage rooms full of tools and supplies that are not reflected in the accounting records. Their time sheets, purchase orders, union reports, and Rolodexes could contain clues leading to unreported income.
- Account for all numerically controlled documents. This is an effective control that is often ignored in practice. I have identified stolen truckloads of scrap metal by investigating gaps in bill-of-lading numbers. In another case, we found stolen funds by obtaining bank copies of checks that were missing from the company's bank reconciliations—they were missing because they had been made payable to the bookkeeper, who changed the payee in the accounting records after the checks were cut.
- Federal Express or other shipping records may disclose off-books customers. Comparing FedEx bills to the debtor's invoice register in one case showed a large number of shipments that the debtor made, but they were billed by on of the manager's other companies instead.
- Look for companies with similar initials or permutations of the owner's initials in the vendor or customer list. For some bizarre reason, people who are creative enough to develop sophisticated fraud schemes cannot seem to

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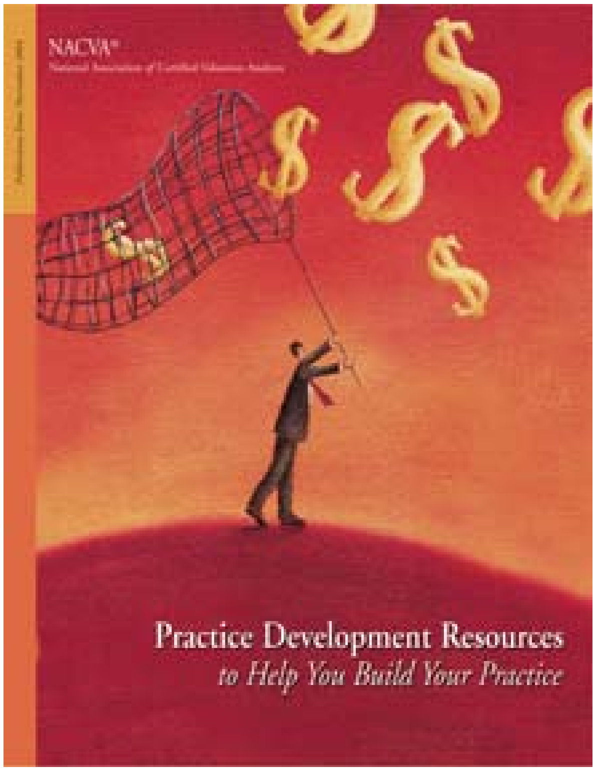

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make up original company names. If you are investigating ABC Company and see vendors named BAC, AbC, and CAB, it is worth a couple minutes to make sure these are not related parties.

- Understand the specific industry you are working in and what records may exist that are peculiar to that industry. Some examples: cashier over/short records in a retail environment, number of hours paid compared to number of hours billed for a maid service, and vehicle maintenance records showing the number of miles driven for a limo service.

To determine the value of a business or the factors behind a bankruptcy, or to propose a divorce settlement, you have to know all of the economic income involved. Money almost always leaves some kind of trail, and cases where it doesn't are so rare that the absence of a trail becomes a primary clue. Curiosity, experience, and an understanding of the subjects involved often lead to those trails and the rewards that lie at their ends. VE

Additional Resources

Books

- *Forensic Accounting and Fraud Investigating for Non-Experts*, by Howard Silverstone and Michael Sheetz, Wiley, NY, 2003 (Available through NACVA)
- *Forensic and Investigative Accounting 2nd Edition,* by Larry Crumbley, ISBN 0-8080-1365-3 (Available through NACVA)
- *Investigative Accounting in Divorce,* by Kalman A. Barson, ISBN 0-471-41832-3 (Available through NACVA)

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Articles

- "Forensic Accounting May Carry the Day," by John Stockdale, Jr., *National Litigation Consultants' Review*, March 1, 2002
- "Be a Bulldog!" by Larry J. Steinberg, *National Litigation Consultants' Review*, August 1, 2002
- "Forensic Accounting and Computer Forensics: A Partnership Solution for Investigation and Litigation," by Jeffrey Gross, *National Litigation Consultants' Review*; May 1, 2003
- "The Fraud Examiners," by Joseph T. Wells, *Journal of Accountancy,* October 1, 2003

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